

capital loss carryover) is \$8,000 (that is, \$12,000 net long-term capital gain less \$4,000 net short-term capital loss computed without regard to the capital loss carryover of \$5,000). The tax attributable to the excess of net long-term capital gain over net short-term capital loss (computed by taking the capital loss carryover into account) is \$750, that is, 25 percent of such excess of \$3,000, computed under section 1201(a)(2). The difference of \$7,250 (\$8,000 less \$750) is the amount allowable as a deduction in computing accumulated taxable income.

(3) Section 631(c) (relating to gain or loss in the case of disposal of coal or domestic iron ore) shall have no application in determining the amount of the deduction allowable under section 535(b)(6).

(g) *Capital loss carrybacks and carryovers.* Capital losses carried to a taxable year under section 1212(a) shall have no application for purposes of computing accumulated taxable income for such year.

(h) *Bank affiliates.* There is allowed the deduction provided by section 601 in the case of bank affiliates (as defined in section 2 of the Banking Act of 1933; 12 U. S. C. 221a(c)).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6805, 30 FR 3209, Mar. 9, 1965; T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7301, 39 FR 964, Jan. 4, 1974; T.D. 7649, 44 FR 60086, Oct. 18, 1979]

§ 1.535-3 Accumulated earnings credit.

(a) *In general.* As provided in section 535(a) and § 1.535-1, the accumulated earnings credit, provided by section 535(c), reduces taxable income in computing accumulated taxable income. In the case of a corporation, not a mere holding or investment company, the accumulated earnings credit is determined as provided in paragraph (b) of this section and, in the case of a holding or investment company, as provided in paragraph (c) of this section.

(b) *Corporation which is not a mere holding or investment company—(1) General rule.* (i) In the case of a corporation, not a mere holding or investment company, the accumulated earnings credit is the amount equal to such part of the earnings and profits of the taxable year which is retained for the reasonable needs of the business, minus the deduction allowed by section 535(b)(6) (see paragraph (f) of § 1.535-2,

relating to the deduction for long-term capital gains). In no event shall the accumulated earnings credit be less than the minimum credit provided for in section 535(c)(2) and subparagraph (2) of this paragraph. The amount of the earnings and profits for the taxable year retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction for such taxable year. See section 561 and §§ 1.561-1 and 1.561-2, relating to the deduction for dividends paid.

(ii) In determining whether any amount of the earnings and profits of the taxable year has been retained for the reasonable needs of the business, the accumulated earnings and profits of prior years will be taken into consideration. Thus, for example, if such accumulated earnings and profits of prior years are sufficient for the reasonable needs of the business, then any earnings and profits of the current taxable year which are retained will not be considered to be retained for the reasonable needs of the business. See section 537 and §§ 1.537-1 and 1.537-2.

(2) *Minimum credit.* Section 535(c)(2) provides for the allowance of a minimum accumulated earnings credit in the case of a corporation which is not a mere holding or investment company. Except as otherwise provided in section 243(b)(3) and § 1.243-5 (relating to effect of 100-percent dividends received deduction under section 243(b)) and sections 1561, 1562, and 1564 (relating to limitations on certain tax benefits in the case of certain controlled corporations), in the case of such a corporation, this minimum credit shall in no case be less than the amount by which \$150,000 (\$100,000 in the case of taxable years beginning before January 1, 1975) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. See paragraph (d) of this section for the effect of dividends paid after the close of the taxable year in determining accumulated earnings and profits at the close of the preceding taxable year. In determining the amount of the minimum credit allowable under section 535(c)(2), the needs of the business are not taken into consideration. If the taxpayer has accumulated earnings and profits at the close of the preceding

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taxable year equal to or in excess of \$150,000 (\$100,000 in the case of taxable years beginning before January 1, 1975), the credit, if any, is determined without regard to section 535(c)(2). It is not intended that the provision for the minimum credit shall in any way create an inference that an accumulation in excess of \$150,000 (\$100,000 in the case of taxable years beginning before January 1, 1975) is unreasonable. The reasonable needs of the business may require the accumulation of more or less than \$150,000 (\$100,000 in the case of taxable years beginning before January 1, 1975), depending upon the circumstances in the case, but such needs shall not be taken into consideration to any extent in cases where the minimum accumulated earnings credit is applicable. For a discussion of the reasonable needs of the business, see section 537 and §§ 1.537-1, 1.537-2, and 1.537-3.

(3) *Illustrations of accumulated earnings credit.* The computation of the accumulated earnings credit provided by section 535(c) may be illustrated by the following examples:

Example 1. The X Corporation, which is not a mere holding or investment company, has accumulated earnings and profits in the amount of \$125,000 as of December 31, 1974. Thus, the minimum credit provided by section 535(c)(2) exceeds the accumulated earnings and profits of X by \$25,000. It has earnings and profits for the taxable year ended December 31, 1975, in the amount of \$100,000 and has a dividends paid deduction under section 561 in the amount of \$30,000 so that the earnings and profits for the taxable year which are retained in the business amount to \$70,000. Assume that it has been determined that the earnings and profits for the taxable year which may be retained for the reasonable needs of the business amount to \$55,000 and that a deduction has been allowed under section 535(b)(6) in the amount of \$5,000. Since the amount by which \$150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year is less than \$50,000 (\$55,000-\$5,000), the minimum credit provided by section 535(c)(2) will not apply and the accumulated earnings credit must be computed under section 535(c)(1) on the basis of the reasonable needs of the business. In this case, the accumulated earnings credit for the taxable year ended December 31, 1975, will be \$50,000 computed as follows:

Earnings and profits of the taxable year determined to be retained for the reasonable needs of the business	\$55,000
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Less: The deduction for long-term capital gains (less applicable tax) allowed under sec. 535(b)(6)	5,000
Accumulated earnings credit allowable under sec. 535(c)(1)	50,000

Example 2. The Z Corporation which is not a mere holding or investment company, has accumulated earnings and profits in the amount of \$45,000 as of December 31, 1974; it has earnings and profits for the taxable year ended December 31, 1975, in the amount of \$115,000 and has a dividends paid deduction under section 561 in the amount of \$10,000, so that the earnings and profits for the taxable year which are retained amount to \$105,000. Assume that it has been determined that the accumulated earnings and profits of the taxable year which may be retained for the reasonable needs of the business amount to \$20,000 and that no deduction is allowable for long-term capital gains under section 535(b)(6). The accumulated earnings credit allowable under section 535(c)(1) on the basis of the reasonable needs of the business is determined to be only \$20,000. However, since the amount by which \$150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year is more than \$20,000, the minimum accumulated earnings credit provided by section 535(c)(2) is applicable. The allowable credit will be the amount by which \$150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year (*i.e.*, \$105,000, \$150,000 less \$45,000 of accumulated earnings and profits at the close of the preceding taxable year).

(c) *Holding and investment companies.* Section 535(c)(3) provides that, in the case of a mere holding or investment company, the accumulated earnings credit shall be the amount, if any, by which \$150,000 (\$100,000 in the case of taxable years beginning before January 1, 1975) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. Thus, if such a corporation has accumulated earnings equal to or in excess of \$150,000 (\$100,000 in the case of taxable years beginning before January 1, 1975) at the close of its preceding taxable year, no accumulated earnings credit is allowable in computing the accumulated taxable income. See paragraph (c) of § 1.533-1 for a definition of a holding or investment company. For the accumulated earnings credit of a mere holding or investment company which is a member of an affiliated group which has elected the 100-percent dividends received deduction under section 243(b), see section 243(b)(3) and

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§1.243-5. For the accumulated earnings credit of a mere holding or investment company which is a component member of a controlled group of corporations (as defined in section 1563), see sections 1561, 1562, and 1564.

(Sec. 1561(a) (83 Stat. 599; 26 U.S.C. 1561(a)))

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6992, 34 FR 826, Jan. 18, 1969; T.D. 7181, 37 FR 8066, Apr. 25, 1972; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7376, 40 FR 42744, Sept. 16, 1975; T.D. 7528, 42 FR 64694, Dec. 28, 1977]

§ 1.536-1 Short taxable years.

Accumulated taxable income for a taxable year consisting of a period of less than 12 months shall not be placed on an annual basis for the purpose of the accumulated earnings tax imposed by section 531. In such cases accumulated taxable income shall be computed on the basis of the taxable income for such period of less than 12 months, adjusted in the manner provided by section 535(b) and § 1.535-2.

§ 1.537-1 Reasonable needs of the business.

(a) *In general.* The term *reasonable needs of the business* includes (1) the reasonably anticipated needs of the business (including product liability loss reserves, as defined in paragraph (f) of this section), (2) the section 303 redemption needs of the business, as defined in paragraph (c) of this section, and (3) the excess business holdings redemption needs of the business as described in paragraph (d) of this section. See paragraph (e) of this section for additional rules relating to the section 303 redemption needs and the excess business holdings redemption needs of the business. An accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business. The need to retain earnings and profits must be directly connected with the needs of the corporation itself and must be for bona fide business purposes. For purposes of this paragraph the section 303

redemption needs of the business and the excess business holdings redemption needs of the business are deemed to be directly connected with the needs of the business and for a bona fide business purpose. See § 1.537-3 for a discussion of what constitutes the business of the corporation. The extent to which earnings and profits have been distributed by the corporation may be taken into account in determining whether or not retained earnings and profits exceed the reasonable needs of the business. See § 1.537-2, relating to grounds for accumulation of earnings and profits.

(b) *Reasonable anticipated needs.* (1) In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.

(2) Consideration shall be given to reasonably anticipated needs as they exist on the basis of the facts at the close of the taxable year. Thus, subsequent events shall not be used for the purpose of showing that the retention of earnings or profits was unreasonable at the close of the taxable year if all the elements of reasonable anticipation are present at the close of such taxable year. However, subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated.